

FRANCHISING AS A SECURITY

When purchasing a franchise for the exclusive right to market the correspondence courses of Continental Schools of America (CSA) in the Dallas-Fort Worth and Houston areas, James McPeck and Venture Investment Co. had relied on CSA's representations that

1. CSA had been in business since 1959;
2. CSA wrote up \$8,000 to \$10,000 worth of business per month in an area the size of each of . . . [the franchisee's] . . . proposed areas;
3. That the CSA courses were licensed by the Colorado State Board of Education as being "par excellence;"
4. That CSA was comprised of a team of experienced personnel who had been successful businessmen prior to joining CSA; and
5. That [CSA] would personally secure the first twenty enrollments.¹

Each of these representations was false. McPeck and Venture Investment sued CSA in federal court² for damages caused by "defendant's fraud, breach of contract, unlawful sale of securities and fraud in connection with the sale of securities."³ Recovery was sought under the Colorado Securities Act,⁴ and the Securities Act of 1933⁵ and Securities Exchange Act of 1934⁶ on the theory that the franchises were investment contracts within the definition of a security.⁷ The district court held that CSA had sold the plaintiffs investment contracts as defined in the Colorado statute. *Venture Investment Co. v. Schaefer*⁸ is the first federal case which holds a franchise to be a security on the basis of either the "risk capital" or "control" test for an investment contract.⁹

The new attitude of the Securities and Exchange Commission (SEC) toward the regulation of certain forms of franchises under the '33 and '34 Acts undoubtedly influenced the outcome in *Venture Investment*.¹⁰ In fact, the district court borrowed much of its reasoning directly from 1933 Act Release No. 5211, in which the SEC declared certain multi-level dis-

¹ *Venture Investment v. Schaefer*, 3 BLUE SKY L. REP. ¶ 71,031 (D. Colo. July 24, 1972).

² Jurisdiction was based on diversity and federal questions arising under the Securities Acts of 1933 and 1934 and Rule 10b-5 of the Securities and Exchange Commission.

³ 3 BLUE SKY L. REP. ¶ 71,031 at 67,232.

⁴ Colorado Licensing and Practice Act, COLO. REV. STAT. ANN. §§ 125-1-12, 125-1-21 (1963).

⁵ 15 U.S.C. §§ 77c-77bbbb (1970).

⁶ 15 U.S.C. §§ 78a-78hh-1 (1970).

⁷ 15 U.S.C. § 77(b) (1) (1970); COLO. REV. STAT. ANN. § 125-1-12 (1963); "Security" under both the federal and state acts means "any note . . . certificate of participation in any profit-sharing agreement . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security.'" 15 U.S.C. § 78c(a) (10) (1970).

⁸ 3 BLUE SKY L. REP. ¶ 71,031 (D. Colo. July 24, 1972).

⁹ Both of these tests will be discussed in detail later.

¹⁰ Since "security" is defined to include "investment contract" under both the federal and state securities acts, it is safe to assume that the rationale of the decision would apply in the same way to a claim brought solely under the federal acts.

tributorship and pyramid franchise plans to be securities.¹¹ Although there is evidence that not all federal courts will follow the lead of *Venture Investment* in applying the rationale of Release No. 5211 for the benefit of franchisees presently seeking remedies against fraudulent franchisors under the Securities Act, the decision represents a significant breakthrough.¹² It is the purpose of this discussion to study the circumstances in which remedies should be available to franchisees under the federal securities acts and to consider various proposals for federal franchise disclosure legislation.

I. THE PROBLEM—AND OTHER ATTEMPTS AT REMEDIES

The facts of *Venture Investment* paint a familiar picture. Along with the boom in franchising over the past ten years¹³ have come frequent abuses.¹⁴ One of the most prevalent abuses is misrepresentation in the sale of the franchise. In many cases, the initial sale produces the bulk of the profit by the franchisor, and so there is an incentive for the franchisor to

¹¹ Securities Act of 1933 Release No. 5211, Securities Exchange Act of 1934 Release No. 9387 (both issued November 30, 1971) [hereinafter referred to as Release]. The Commission adopted a more liberal test for an "investment contract" than the traditional *Howey* test, stating that if the investor does not control his investment to a significant degree, a security exists.

¹² S.E.C. Chairman William J. Casey recently called on Congress to clarify the authority of the Securities and Exchange Commission over pyramid plans. Recently, the S.E.C. attempted to apply existing securities laws to the pyramid-selling operations of Glenn W. Turner Enterprises, Inc. in Portland, Oregon. The federal district court did grant the S.E.C. a preliminary injunction against further sales of "Dare To Be Great" motivational and self-improvement courses, but the S.E.C. was denied its request for a receiver and for repayment of money to "Dare To Be Great" participants. SEC v. Glenn W. Turner Enterprises, Inc., CCH FED. SEC. L. REP. ¶ 93,605 (May 25, 1972). The case is on appeal. Thus, Mr. Casey stated that the case cannot be relied on to establish S.E.C. authority over the pyramid sales plans. Wall Street Journal, Sept. 12, 1972, at 6 col. 1.

¹³ "In its broadest sense, the franchise system now accounts for 80 billion dollars in annual sales, or 10% of the Gross National Product, and more than 20% of all retail sales, with well over 700 franchisors and as many as 500,000 franchisees." H. BROWN, FRANCHISING: TRAP FOR THE TRUSTING 2 (1969) [hereinafter cited as TRAP]. See also the *Report of the Select Committee on Small Business on the Impact of Franchising on Small Business* S. REP. NO. 91-1344, 91st Cong., 2d Sess. (1970) [hereinafter cited as 1970 Report]. The Select Committee on Small Business found as follows:

Franchising is quite often regarded as one of the 'newest' marketing concepts on the American business scene. Actually, the franchising concept has been utilized successfully by American businessmen for over 70 years. General Motors adopted franchising in 1898, followed by Rexall in 1902. What is truly new about franchising is the recent phenomenal growth of franchised businesses in all areas of marketing. Approximately 90 percent of the franchise companies now in operation have started since 1954.

New franchisees are coming into the system at the rate of approximately 40,000 per year. During the past 5 years, the number of companies offering franchises has more than tripled.

1970 Report at 7.

¹⁴ Three major abuses have arisen: (1) dishonest franchisors have used misrepresentations and half-truths to sell the franchise; (2) after completion of the sale, some franchisors have failed to deliver the franchised business ready for operation within a reasonable time; (3) some franchisors have unreasonably terminated the franchise. Augustine and Hrusoff, *Franchise Regulation*, 21 HASTINGS L.J. 1347, 1365 (1970).

paint a glowing picture for the franchisee in order to secure the sale.¹⁶ The franchisor can then afford to be relatively unconcerned about whether or not the franchisee has gross sales sufficient to continually order products from the franchisor or to pay royalties, which do not substantially increase the profits of the franchisee. The franchisee, after having been induced to invest by the glowing profit pictures painted by the franchisor, often finds that he has lost his investment.

Remedies under state law are often inadequate to meet the problem of fraud in the sale of franchises.¹⁶ For example, a franchisee seeking rescission of the franchise contract¹⁷ has to prove that when purchasing the franchise he relied upon the franchisor's misrepresentation of a material fact. Although the franchisee need not prove scienter, he does need to overcome the materiality problem.¹⁸ The distinction between a statement of "fact" and mere opinion or "puffing" is also critical to the franchisee's case.¹⁹

If the franchisee brings an action in deceit, he then meets two formidable obstacles to proof: (1) Scienter and causation, and (4) materiality and reliance.²⁰ In a common law breach of warranty action,²¹ the franchisee faces all the intricacies of the parol evidence rule,²² and if successful, he often finds the franchisor to be insolvent. In sum, the state common law remedies are complicated and inadequate and often, the franchisee will find himself without relief.²³

On the federal level, remedies are equally unsatisfactory. Franchisors who use fraudulent representations to secure a sale and who use an instrument of interstate commerce to complete the sale are subject to prosecution for mail fraud²⁴ and to action by the Federal Trade Commission (FTC) for unlawful "deceptive acts or practices in commerce,"²⁵ but the individual

¹⁶ Augustine and Hrusoff, *Franchising Under the Securities Acts of 1933 and the California Corporation Code*, 44 L.A. BULL. BAR 555, 576 (1969).

¹⁶ The fraud problem in the sale of franchises has been dealt with through specific legislation in some states.

¹⁷ Either affirmatively or a defense to a breach of contract action brought by the franchisor.

¹⁸ 37 AM. JUR. 2d *Fraud and Deceit* § 12 (1968).

¹⁹ *Id.*

²⁰ *Id.*

²¹ A breach of warranty action under the Uniform Commercial Code may not be available because the sale of a franchise does not fit readily into the Code's definition of a "sale." It is a licensing agreement, rather than a transaction in goods. See UNIFORM COMMERCIAL CODE §§ 2-105, 2-106 (1962 version).

²² Franchise contracts are commonly in writing. Therefore, the franchisee may not be able to introduce evidence of oral misrepresentation unless he can show that the writing was not an integration of the agreement.

²³ The problems discussed in reference to recovery under the common law for injuries suffered as a result of fraud are general and by no means limited to the franchise situation.

²⁴ 18 U.S.C. §§ 1341, 1343 (1970).

²⁵ 15 U.S.C. § 45(a) (1970).

plaintiff is not given any right of action under the FTC Act.²⁶ Rather, the FTC sues in the name of the United States to halt the practice.²⁷

The franchisee seeking damages for the loss of his investment under state common law remedies or under the FTC Act will find the road to money recovery a rocky one.

II. FRANCHISEES TURN TO THE SECURITIES LAWS

Because recovery under various state and federal laws is so difficult, franchisees who have been duped by fraudulent franchisors have begun to seek relief²⁸ under state and federal securities laws.

The initial hurdle faced by the franchisee seeking recovery under the securities laws is the necessary showing that the franchise which he purchased is a security. This is a formidable problem, but assuming he can overcome this burden, his road to recovery under the securities laws is free of the intricacies of pleading and proof present in other actions.

To state a cause of action under § 12(1) of the Securities Act a plaintiff need only show:

1. that the franchisor was a seller, or under § 15, a person in control of a seller;
2. that the mails or some means of transportation or communication in interstate commerce was used in connection with the offer or sale of the security to the particular purchaser;
3. that the seller failed to comply with either the registration or prospectus requirements;
4. that plaintiff is bringing the action within the statute of limitations;
5. if plaintiff is seeking rescission, that he properly tendered the security to the seller.²⁹

Besides the fact that all of these elements are simple for the franchisee to show,³⁰ the defendant's only defense is to show that the transaction was exempt from registration under § 5.³¹

²⁶ 15 U.S.C. §§ 41-58 (1970). A successful FTC action can be used as a predicate for a private suit. However, the FTC does not bring suit in all cases in which they have received a complaint from a victim of an "unfair or deceptive trade practice." Thus, the injured party may find himself awaiting FTC action which may never be taken.

²⁷ *Id.* § 45.

²⁸ Civil liability was often the only effective remedy under state blue-sky laws. Criminal prosecutions were rare because of inadequate budgets. L. LOSS, *SECURITIES REGULATION* 1631 (1961).

²⁹ 15 U.S.C. § 771 (1970).

³⁰ The simplicity of § 12(1) is paralleled in many state securities acts. It is likely that the franchisor did make use of the mails in dealing with the franchisee; it is unlikely that the franchisor registered his "franchise-security" before he offered it for sale.

³¹ The defense most often used was to resist the contention that the franchise was a security and thus show that the transaction was not subject to the Act.

III. THE INVESTMENT CONTRACT AND THE COURTS

As pointed out above, the threshold problem faced by a franchisee seeking recovery under the securities laws is the characterization of his franchise as a security. Franchisees have most often argued that the franchise contract was actually an "investment contract" within the definition of a security³² as formulated in *SEC v. W. J. Howey Co.*,³³ i.e. (1) there must be a common enterprise, and (2) the investor must expect to derive his profits solely from the efforts of others.³⁴ The second element of this test has proved to be the major stumbling block for many franchises. The district court in *Drug Management, Inc. v. Dart Drug Corp.*³⁵ rendered an interpretation of the "profits derived solely from the efforts of others" test which is characteristic of the strict interpretation given the *Howey* test by many state and federal courts.

Dart Drug, unlike *Howey*, involved a franchise contract³⁶ in which the franchisor had agreed to provide the franchisee with an exclusive franchise for drug stores in the Charlotte, North Carolina area. The district court found that the franchise contract did not constitute an investment contract because the franchisee performed some duties. It did not, however, consider whether these were managerial or ministerial duties, nor did it consider the possibility that the *Howey* test may not have been the only test for an investment contract. Under *Dart Drug*, a franchisee who performed only ministerial duties, appearing to be more like an employee than an independent businessman, might still be characterized as having "control" over his franchise.

It was at the state level that the harshness of *Dart Drug* was first softened. In 1967, Anthony Pierno, Attorney General of California, wrote an opinion making it clear that the California Corporation Commission would consider a franchise to be a security in two situations:

(1) Where the franchisee participates only nominally in the franchised business; or (2) where the franchisee participates actively in the franchised business and where the franchisor agrees to provide certain goods and services to the franchisee, but where the franchisor intends to secure a substantial portion of the initial capital that is needed to provide such goods and services from the fees paid by the franchisee or franchisees.³⁷

After formulation of this test, California franchisees, who were able to show that they performed no important managerial functions in the

³² 15 U.S.C. § 77b(1) (1970).

³³ 328 U.S. 293 (1946).

³⁴ *Id.* at 298-99.

³⁵ CCH FED. SEC. L. REP. ¶ 91,293 (D.D.C. 1963) [hereinafter cited as *Dart Drug*].

³⁶ One author argues that *Dart Drug* did not involve a franchise agreement, but rather involved a sale of data concerning the operation of a drug store. See Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969).

³⁷ 49 OPS. CAL. ATT'Y GEN. 124 (1967).

operation of the franchise or who could demonstrate that the franchisor used part of the franchise fee to provide capital for the franchisor's business,³⁸ could afford themselves of remedies resulting from the franchisor's failure to register the "security-franchise."³⁹

The California test is a two-pronged attack on the definitional difficulties in finding a franchise to be a security.⁴⁰ First, California adopted the "risk capital" test, which at least one legal scholar had proposed as the most essential indication of a security.⁴¹ Second, California adopted a liberal interpretation of the *Howey* test. No longer would mere ministerial control be regarded as the kind of control which would indicate that profits were not "derived solely from the efforts of others." It was enough that either the "risk capital" test or the "control" test be satisfied to find a franchise to be an investment contract.

IV. DEVELOPMENTS IN THE FEDERAL COURTS

Soon after formulation of the California test, franchisees began to urge its adoption by the federal courts in actions brought under the Securities Act of 1933 and the Securities Exchange Act of 1934. The first case, *Chapman v. Rudd Paint & Varnish Co.*,⁴² involved a franchise distributorship agreement. After failure of the distributorship, Chapman sued Rudd for selling an unregistered security under Section 12(1) of the Securities Act of 1933, arguing that he did not exercise *managerial* control over his investment and therefore did derive profits "solely from the efforts of others." The court of appeals disagreed, finding that the distributorship agreement did not provide that Chapman was to obtain profits *solely* from the efforts of others, and that the brochure sent to Chapman during the bargaining stage did not lead him to expect profits derived solely from the efforts of others.⁴³ Consequently, the distributorship agreement was held not to be an investment contract.

³⁸ If the franchisee could demonstrate that the franchise fee was disproportionate to the value of the franchisor's license and the goods and services franchisor could provide, the franchisee had a good argument that part of the fee was being used to capitalize the franchisor's business.

³⁹ CAL. CORP. CODE § 25500 (West Supp. 1971).

⁴⁰ The sale of securities in California is regulated through the issuance of permits:

No company shall sell any security of its own issue, except upon a sale for a delinquent assessment against the security made in accordance with the laws of this State, or offer for sale, negotiate for the sale of, or take subscriptions for any such security, until it first applied for and secured from the commissioner a permit authorizing it to do so.

CAL. CORP. CODE § 25500 (West Supp. 1971).

⁴¹ See Coffey, *Economic Realities of a Security*, 18 W. RES. L. REV. 367, 374 (1967). It is Mr. Coffey's contention that the *Howey* test is "incomplete or misleading with respect to certain essential qualities of a security." He argues that the *Howey* test ignores the risk of loss to the original value furnished by the purchaser and that this risk to original value is the single most important characteristic of a security.

⁴² 409 F.2d 635 (9th Cir. 1969).

⁴³ The brochure sent to the plaintiff is pertinent because the Securities Act of 1933 prohibits

Although plaintiff urged a more liberal interpretation of the *Howey* control test,⁴⁴ the court of appeals retained the strict *Dart Drug* interpretation, thereby illustrating that the federal courts would ignore the progressive approach taken in California for some time to come. Such a view meant that franchise agreements could qualify as securities only in these rare cases when the franchisee performed no function whatever in the operation of the franchise.

But the California test was not ignored by the federal courts for long. The first federal case to give full consideration to the California test was *Mr. Steak, Inc. v. River City Steak, Inc.*⁴⁵ The facts of *River City* are worthy of close consideration. Mr. Steak sold to River City Steak a franchised restaurant operation for an initial investment of \$35,000, with further payments to be based upon a percentage of the weekly gross sales of the restaurant. The franchise agreement required River City Steak to execute a "restaurant manager's agreement" with one Zenck, who had been recruited and trained by Mr. Steak. Mr. Steak was to be responsible for constructing and equipping the establishment and training the manager; River City was to carry insurance, maintain trade secrets, submit to inspections, and appoint an agent to accept process. River City also agreed not to compete with Mr. Steak and to use certain uniforms and certain franchisor products exclusively. River City was to give Mr. Steak exclusive right to train a manager, to spend specific sums on advertising, and was to allow Mr. Steak to participate in the initial hiring and opening of the restaurant.⁴⁶

The court viewed these provisions as necessary for Mr. Steak to maintain "uniformly high standards to promote its own continued growth,"⁴⁷ although it admitted that these are not ordinarily found in other business contracts. The court further found these provisions to be consistent with a finding of managerial control by River City.

The agreement further provided that either the franchisee or the fran-

the offer as well as the sale of unregistered non-exempt securities. The court of appeals found that the brochure emphasized the minimal amount of effort that the franchisee would have to make in order to derive profits. In addition, the brochure contained profit projections supposedly based on market tests. It repeatedly emphasized the profit-making efforts of Rudd in the distributorship plan and described the distributorship as a turn-key operation into which the investor may step, "whereupon he is immediately involved in . . . a substantial and profitable undertaking with a minimum obligation on his time and resources."

The court found that the very fact that the brochure emphasized the amount of assistance the company would provide implied that the franchisee was to make some effort. Because the brochure contained no financial data on Rudd, or any balance sheet figures or past earnings record, the court found that the brochure was not a prospectus.

⁴⁴ The plaintiff urged the court to apply the California view of the *Howey* test. Under this view, Chapman would have to exercise real managerial control over the distributorship in order for the franchise to be found not to be an "investment contract." The Court did not consider the California risk capital test in deciding the case.

⁴⁵ 324 F. Supp. 640 (D. Colo. 1970).

⁴⁶ *Id.* at 642.

⁴⁷ *Id.*

chisor, if the former failed to act, could select the manager. However, Mr. Steak selected Mr. Zenck as manager without consulting River City. The franchise agreement further specified that the manager was to operate the restaurant as a "sanitary, efficient and high quality Mr. Steak restaurant,"⁴⁸ as defined by Mr. Steak's directives. The agreement specified the manager's salary and required him to invest in the franchisee's stock. (In this case, Mr. Zenck invested \$5,000 in River City Steak stock, but was required to assign his stock to Mr. Steak.)⁴⁹ The manager was to be the only person who actively managed the franchise; and if he did not comply with the orders of Mr. Steak, which according to the agreement had "the power to supervise, instruct, and direct the activities, duties and functions of the Investor-Manager,"⁵⁰ he could be removed at the absolute discretion of Mr. Steak. If Mr. Steak chose to fire the manager, River City Steak had no voice in appointing a new manager.

The court stated that these provisions seemed to afford actual control of the restaurant to Mr. Steak, but found further language in the agreement which required the manager to operate the restaurant in "an honest and upright manner,"⁵¹ according to specifications set up by the *franchisee* as well as the franchisor. The franchisee also had the right to terminate the manager's employment upon two weeks' written notice to Mr. Steak and the manager.

The court saw these two factors as important evidence that the manager retained some managerial control over the enterprise, but was troubled by other facts which demonstrated that River City abdicated control over its financial affairs. In order to secure the franchise, River City was required to give Mr. Steak the power to pay all salaries and accounts payable from its bank accounts and to give Mr. Steak weekly franchise fees and meat counts, invoices, tickets for items purchased, records of cash received and deposited, duplicate bank deposit slips, duplicate cash register slips, and receipts for items paid for in cash by the franchisee. In addition, the franchisee's bank sent all account statements and daily deposit verification slips directly to Mr. Steak. On the basis of these requirements the district court found that

[t]he practical consequence . . . was to afford Mr. Steak an effective control system over the franchisee's receipts and operations. The cost to the franchisee . . . [was] loss of control over *some* phases of the financial operations *although his business judgment need not be otherwise impaired*.⁵²

⁴⁸ *Id.*

⁴⁹ If Zenck's employment were terminated, he would receive a like amount or the actual value of his stock whichever were greater.

⁵⁰ 324 F. Supp. at 643.

⁵¹ *Id.*

⁵² *Id.* at 643-44 (emphasis added).

But the district court further found that the franchise agreement and the manager's agreement contemplated that River City would "play an active, if severely circumscribed role, in the conduct of the restaurant,"⁵³ and thus the district court held that River City did exercise managerial control over its investment.

The court then considered the facts under the "risk capital" test and concluded that the California test was "too extreme."⁵⁴ In the court's judgment, a better view of the risk capital test would limit application of the 1933 Act to "situations where exceptionally high risk, speculative franchises are involved,"⁵⁵ but since Mr. Steak had over 200 successful franchises in operation, it was not shown to be poorly financed or highly speculative. Neither was River City solely dependent on Mr. Steak for supplies:

Defendant [River City] assured itself a supply of necessary food products independently of Mr. Steak, which specified products, available from suppliers other than itself, that were to be used in restaurant operations. Given the initial costs, including construction, incident to opening the restaurant, and excluding accounting services of dubious value supplied by Mr. Steak, we think it fair to conclude that River City Steak, Inc.'s, investment in plaintiff's business comprised the purchase of the Mr. Steak name and method of doing business. Any "risk" to River City Steak created by that purchase is an insubstantial and legitimate risk of doing business.⁵⁶

Having found that River City controlled its investment in the franchise and that the risk capital test was inapplicable, the court held that no investment contract had been sold under the facts of the case.

The decision ultimately rested on the court's finding that River City controlled its franchise, but the district court took an extreme view of what constituted real managerial control over a business. The court placed great emphasis on the franchisee's power to fire the manager who had been hired and trained by Mr. Steak, but that power should be considered in conjunction with the fact that if the manager were fired, River City would have had no voice in the hiring of a new manager. While it was true that the manager was to run the restaurant according to the directives of the franchisee as well as the franchisor, it was also true that River City surrendered all power "to supervise, instruct, and direct the activities, duties and functions of the Investor-Manager,"⁵⁷ and that the manager was given the "sole right to manage and control the daily operation and affairs of the Mr. Steak restaurant." Presumably, if the directives of the franchisee and the

⁵³ *Id.* at 645. The district court applied the "better approach and the one which the Supreme Court in *Howey* noted was being employed by the state courts . . . to disregard form for substance and place emphasis on economic reality." *Id.* at 644-45.

⁵⁴ *Id.* at 647.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.* at 643.

franchisor conflicted, Mr. Steak would have prevailed for this reason. In practice, the provisions on which the court relied to find some managerial control in the hands of the franchisee were overridden by conflicting provisions giving control to the franchisor, and, therefore, the apparent control in the hands of the franchisee was a nullity.

The court, strongly influenced by the then current view that the Securities and Exchange Commission should not involve itself in the franchise problem,⁵⁸ readily accepted evidence of the slightest measure of control by River City as evidence of managerial control:

Our conclusion is supported by weighty considerations. The registration provisions of the 1933 Act are ill-suited to fostering disclosure of information relevant to prospective franchisees. . . . In view of the Commission's position, the complex problems involved and the impact of this industry on our national economy we agree that judicial imposition of the 1933 Act upon the sale of franchised businesses may be inappropriate. Such a step should properly be taken by the Congress or state legislatures.⁵⁹

The court's findings that River City had assured itself a supply of necessary food products independent of Mr. Steak and that the franchise fee was proportionate to the value of Mr. Steak's method of doing business were perhaps the most influential in determining the outcome of the case. The court concluded from these facts that even if Mr. Steak failed, the franchisee was in a position to carry on business without losing his investment, particularly since he did have some skill in the restaurant business. The court distinguished this from the situation in which failure of the franchisor's business results in certain failure for the franchisee.⁶⁰

The district court is probably correct in its conclusion that where the

⁵⁸ "If disclosure is to be obtained in the franchising area, this should be by the enactment of separate legislation rather than . . . simply changing the definition of security in the Securities Act so as to make a franchise a security thereunder." Statement of Philip A. Loomis, Jr. General Counsel, Securities and Exchange Commission, in *Hearings on the Impact of Franchising on Small Business Before the Subcommittee on Urban and Rural Economic Development of the Senate Select Comm. on Small Business*, S. REP. NO. 91-1344, 91st Cong., 2d Sess. 706 (1970) [hereinafter cited as 1970 Hearings].

Further evidence of the extent to which this district court was influenced by the opinion of the Securities and Exchange Commission is the fact that the district court which decided *River City* also decided *Venture Investment*. But *Venture Investment* was decided after the Securities and Exchange Commission changed its position on certain franchising plans in Release No. 5211.

⁵⁹ 324 F. Supp. at 647.

⁶⁰ The court made much of the fact that investors in *Howey* were out-of-state investors who knew nothing about the citrus-growing business. Therefore, they had to rely on the skill of the *Howey-in-the-Hills Co.*, for a return on their investment. In *River City*, however, the franchisee had some previous experience in the restaurant business. This indicated to the court that River City could have controlled the franchise if it had wished, but the court is confused on this issue. While it may have been possible for River City to salvage some of its investment if Mr. Steak had failed, it was not possible under the franchise contract, as it existed, for River City to put to use any of its managerial skills. In order to secure the franchise, River City was forced to rely on Mr. Steak's skills for any return on its investment.

failure of the franchisor results in certain failure for the franchisee,⁶¹ the franchisee cannot be said to have control over his investment.⁶² However, the converse of this assertion may not be true, for even though the failure of the franchisor does not portend certain failure for the franchisee, it does not necessarily follow that the franchisee has real managerial control over his franchise. In the facts of *River City*, for example, the franchisee may well have been able to salvage part of his investment if Mr. Steak failed (although Mr. Steak was evidently not a candidate for business failure). The relevant question should be whether the franchisee maintained discretion over his investment, regardless of whether the franchisor operated a healthy business. Because the franchisee exercised so little control over the business, it appeared that River City had, in exchange for a return on its investment, simply financed a new outlet for Mr. Steak. The amount of return depended on how well Mr. Steak and its manager ran the restaurant, *not* on the managerial efforts of River City.

V. CHANGE IN THE COMMISSION'S VIEW

The view given the control aspect of the California test in *River City* did not, however, serve to re-entrench an exacting interpretation of the control test in the state courts. Hawaii followed California's lead in developing a more progressive approach to the franchise investment contract problem. In *Hawaii v. Hawaii Market Center, Inc.*,⁶³ the Hawaii supreme court dealt with a pyramid distributorship plan and formulated a test different from California's. Under the Hawaii test, a franchise is an investment contract when

- (1) an offeree furnishes value to an offeror, and
- (2) a portion of this initial value is subjected to the risks of the enterprise, and
- (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
- (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.⁶⁴

The Hawaii test differs from the California test in that the franchisee must show both lack of managerial control and subjection of the franchise

⁶¹ As in a distributorship agreement where the franchise fee has been used to capitalize the franchisor.

⁶² If presented with a fact pattern similar to *Chapman*, the *River City* court would have found an investment contract, *i.e.*, if presented with evidence that part of the franchise fee had been used to capitalize the franchisor's business.

⁶³ 485 P.2d 105 (Hawaii 1971).

⁶⁴ *Id.* at 109. Much of the Hawaii test is borrowed from the test proposed by Professor Coffey. See Coffey, *supra* note 41.

fee to the risks of the franchisor's business. Under this test, it is not enough that the franchisee lacks control over his franchise, nor is it enough that the franchisor is using the franchise fee to capitalize his own business. Both conditions must exist before a franchisee can satisfy the definition of investment contract under the Hawaii test.

It was this test that the Commission adopted when it cracked down on pyramid franchising last year. The Commission's release modified the former view that franchising should not be regulated under the Securities Act of 1933 and the Securities Exchange Act of 1934.⁶⁵ The more liberal view taken by the Commission was as follows:

The term "security" must be defined in a manner adequate to serve the purpose of protecting investors. The existence of a security must depend in significant measure upon the degree of managerial authority over the investor's funds retained or given, and performance by an investor of duties related to the enterprise, even if financially significant and plainly contributing to the success of the venture, may be irrelevant to the existence of a security if the investor does not control the use of his funds to a significant degree. The "efforts of others" referred to in *Howey* are limited, therefore, to those types of essential managerial efforts but for which the anticipated return could not be produced.⁶⁶

The release gave notice that the Commission will consider multi-level distributorships and pyramid sales plans to be securities (1) when the franchisee does not exercise managerial control over his investment, and (2) when the investment by the franchisee finds its way into the capital account of the franchisor.⁶⁷ It may also influence the federal courts to take a lib-

⁶⁵ Release, *supra* note 11.

⁶⁶ *Id.* at 33—5211. The Commission takes a view of the control test which conflicts with the *River City* view. Realistically, it could not be said that *River City* performed those "types of essential managerial efforts but for which the anticipated return could not be produced."

⁶⁷ In the multi-level distributorship plan, the manufacturer represents that it intends to manufacture or sell a product. It then purports to offer franchises for distributing these products. For a relatively small fee, the purchaser is supplied with a sample inventory and he is authorized to make sales to the public. For a larger fee, the franchisee receives a wholesale inventory which he supervises. For an even larger fee, he may purchase the right to be the "link" between the manufacturer and the rest of the distributorship chain.

In the pyramid sales plan, funds are solicited from a certain number of "founders" to construct a retail store that is owned and operated by the promoters of the plan. The "founders" are given an identification card which they are to pass along to prospective customers of the store. When the store opens, these cards are presented upon making a purchase and the "founder" will receive a commission on that sale. For other cases dealing with multi-level distributorships and pyramid sales plans see *Frye v. Taylor*, No. 70-952 (Fl. Ct. App. March 9, 1972) (a pyramid franchise for the sale of cosmetics was found to be an "interest in or under a profit-sharing or participation agreement or scheme"); *Shaul v. Consumer Companies of America, Inc.*, No. 72CV-03-824 (C.P. Franklin County, Ohio, March 28, 1972) (representative contracts in a merchandising plan entitling investors to receive commissions for sales and for recruitment of other representatives are investment contracts which are securities under the blue sky provisions of the Ohio Code); *Oklahoma v. World Trade Markets Centers, Inc.*, CJ-72-1575 (Dist. Ct. Okla. City June 2, 1972) (sale of dealer and key dealer contracts was equivalent to a sale of securities in that investors were asked to contribute capital for a venture in which they had no right of control).

eral view of what constitutes an investment contract.⁶⁸ Since the district court which heard *River City* is the same court which decided *Venture Investment*, it may be safely assumed that the Commission's change in attitude prompted the change in that outlook.⁶⁹

Venture Investment is the first federal case to hold that a franchise is an investment contract on the basis of the SEC-Hawaii test. The district court specifically found that both parts of the test had been satisfied under the facts of the case. First, the franchise fee had been used as capital "for the very basic elements of setting up the franchise system of operation as a whole,"⁷⁰ and second, the franchisee had no control over the essential managerial aspects of the correspondence school business.

The finding on the control issue causes some confusion since it appears from the facts of the case that the franchisees were given complete control over the manner in which they chose to sell the franchisor's courses. In *Venture Investment* the undercapitalization of the franchisor determined the finding on the control issue. Once the franchisee's investment found its way into the franchisor's capital account, it was thereafter impossible for the franchisees to exercise real control over their investments, short of making management decisions in the franchisor's business. The court was therefore correct in its conclusion that the franchisees had no managerial control over their franchises.

The change in attitude of the Commission may explain to a large degree the different results in *Venture Investment* and *River City*, but perhaps an even more important influence on the courts was the increased risk to the franchisee when the franchisor was inadequately capitalized. In *River City*, the franchisor had other franchises operating smoothly and had thereby demonstrated that it could live up to its part of the bargain. Had the franchisee held complete managerial control, he would have run only the risk of failure that is attendant to the operation of any business. This is to be distinguished from the situation in *Venture Investment* where the

⁶⁸ The federal courts may ignore a release of the Securities and Exchange Commission because it does not have the force of law that a rule or regulation has. See L. LOSS, *SECURITIES REGULATION* 1894 (1961). But usually the courts give "controlling" weight to Commission interpretations. *Id.* at 1930. The *River City* decision has been affirmed by the Court of Appeals for the 10th Circuit. This does not indicate that the court of appeals has ignored the release since *River City* did not involve a pyramid franchise plan. Indeed, the control issue in *Venture Investment* and *River City* are substantially different. It does, however, indicate that there will be no great willingness, at least in the 10th Circuit, to read the release broadly. The Commission may have thrown out the release to see if the courts would accept it. The Commission has received some negative feedback and is now requesting legislation from Congress to clarify the Commission's authority over pyramid franchising. See note 11 *supra*.

⁶⁹ The true test of how the federal courts will receive the change in attitude of the Commission will come if *Venture Investment* goes up on appeal. If the case is affirmed, the Commission will have a strong precedent on its side confirming its authority over pyramid franchising. The *River City* affirmation may stand as precedent that the court will not accept further extension of the Commission's authority over franchising without Congressional action on the matter.

⁷⁰ 3 BLUE SKY L. REP. ¶ 71,031 at 67,233 (1972).

franchisor was not adequately capitalized, having no other franchise outlets to demonstrate that it could deliver correspondence courses, the product of the franchise business, even if McPeck and Venture Investment made sales. Thus even if a highly ambitious franchisee did prove to be a successful salesman, there was no guarantee that his business would succeed.

This problem of the franchisor's capitalization is inextricably related to the control issue, since if the franchisor is inadequately capitalized, he will almost invariably use the franchise fee to finance his own operations, thereby taking control of the investment away from the franchisee. This was the case in *Venture Investment* where the franchisee admittedly could regulate the method of sale and could perform other managerial functions. In *River City*, even though most of the managerial control was retained by the franchisor, the entire investment (or at least a significant portion of it) went toward the individual operation of the franchisee.

The crucial difference, then, between *River City* and *Venture Investment* is in the amount of control exercised by the franchisee *over his own investment*. In *River City*, the franchisee appeared to have little control over the franchise business, but at least his investment went toward financing his own outlet. In *Venture Investment*, the franchisee appeared to have complete discretion over the franchise business, but because of the undercapitalization of the franchisor, most of the investment had been taken by the franchisor to finance his own operations.⁷¹ It was the failure of the franchisor over which the plaintiff in *Venture Investment* had no control, and his risks were significantly different for that reason. The emphasis placed on the risk capital aspect in these cases leads one to believe that the

⁷¹ Even before the Release and *Venture Investment*, potential franchisors were being advised to keep the franchise fee separate from their capital account so that it could not be said that any part of the franchise fee was risk capital and to calculate carefully the exact cost of the franchise so as to avoid the accusation that the cost was disproportionate to the amount of goods and services the franchisor could ever hope to provide:

The test appears to revolve around the purpose of the sale of the franchise and the use of the fee itself. If, in fact, the selling of the franchises is more important to the company as a means of raising capital than the obvious purpose of expanding its market penetration, there arises at least a superficial argument that the franchise income is not income but capital contributions. This interpretation supports the contention that it is not the franchises that are being sold, but the stock of the franchise company.

C. ROSENFELD, *THE LAW OF FRANCHISING* § 216 (1970). [hereinafter referred to as *LAW OF FRANCHISING*]. Franchisors were also advised to take special care in wording their advertisements and to be wary that if they offered that franchise on an absentee-ownership or management fee bases, then their franchise offering may actually be viewed as a security.

In this circumstance, [absentee ownership] the franchise company, through the sale of the franchise, is generating its own growth on the investment of the franchisee and the purchase of the franchise is merely a funding to the company of an added outlet. The return or income to be earned by the franchisee is really a return on investment. The absence of active participation leaves only the money invested as the force generating the income. This combination of facts creates a "securities" situation under the definition of the Securities Act.

Id. § 213.

courts may be likely to find a security in situations where only the risk capital test is satisfied.

Since the release, only two trial courts⁷² have faced the *River City* type of control problem where there has been no evidence of undercapitalization of the franchisor. Because of the special facts of the two cases, neither sheds light on the question of what the federal courts might do if faced with a franchise contract similar to the one in *River City*. However, the 10th Circuit Court of Appeals has since affirmed the decision in *River City*,⁷³ offering some evidence that the federal courts may not accept any further broadening of the definition of investment contract to include situations in which the franchisor is not using the franchise fee to capitalize his own business.

It is worthwhile to examine the circumstances in which a franchisee might come to a federal court in seeking relief under the federal securities acts. There are four basic situations:

1. If the franchisee can show that the franchisor is undercapitalized and that the franchisee, according to the franchise contract, or in practice, has no real managerial control over his franchised business, his franchise will be found to be a security. The undercapitalization of the franchisor raises the suspicion that the money invested by the franchisee has not only purchased a franchise for the franchisee but also has financed the franchisor's business. A franchise fee which is disproportionate to the value of the licensing agreement and the value to the franchisee of the franchisor's method of doing business will raise the same suspicion. These circumstances satisfy the Hawaii test, and the federal courts will probably follow the import of the Commission's release and apply the Hawaii test even to situations where pyramid franchises are not involved.

2. If the franchisor is capitalized adequately, but the franchisee has no real managerial control over the franchise, it is difficult to say what the

⁷² In *Huberman's v. Denny's Restaurant, Inc.*, 337 F. Supp. 1249 (N.D. Cal. 1972), an action based on the Security Exchange Act of 1934, there was no evidence that any part of the plaintiff's purchase price for the franchise and related property served to finance the franchisor's business. The contract between the parties provided that the plaintiff was to play no part whatever in the operation of the restaurant but was to derive her profits from a percentage of the restaurant sales each month. The court applied the "profits derived solely from the efforts of others test" and found that an investment contract existed. The court distinguished *Huberman* from *River City* on its facts, and indeed, the facts in *Huberman* would appear to satisfy the strictest rendition of the *Howey* test.

On July 25, 1972, *Beefy Trail, Inc. v. Beefy King International, Inc.*, CCH FED. SEC. L. RBP. ¶ 93,603 (M.D. Fla. July 25, 1972) was decided. Again, there was a risk capital problem in the case. The court found that the franchisee was an experienced businessman, who handled the day-to-day operations of the restaurant and made managerial decisions. The court found that the franchise was not an investment contract. Even under a liberal view of the *Howey* test, this franchise would probably not qualify as an investment contract. The role of the franchisor was not great in the daily operation of the franchise, and there was no capitalization problem.

⁷³ CCH FED. SEC. L. RBP. ¶ 93,476 (10th Cir. 1972). The court of appeals did not shed any new light on the decision in the lower court. It simply adopted its reasoning and affirmed.

courts may do. This is essentially the *River City* situation and *River City*, as stated above, was affirmed by the 10th Circuit after the Commission's release.⁷⁴ However, other circuits may either choose not to follow the *River City* version of the control test in light of the Commission's release or they may distinguish future cases on their facts. Some courts may find that the franchisee is simply a passive investor who has financed an outlet for the franchisor, with the investor's return coming solely from the efforts of the franchisor.⁷⁵ This would be satisfaction of the liberal *Howey* test but there is no assurance that the courts will take this route without clarification of the matter by the Commission or Congress.

3. The third situation is one in which the franchisor is shown to be inadequately capitalized or where the franchise fee is disproportionate to the amount of goods or services the franchisor can realistically provide, but where the franchisee has complete discretion to operate his franchise (essentially a *Venture Investment* situation). Following the lead of *Venture Investment*, the courts will find that the franchisee lacks control over his business because the franchise fee is being used to capitalize the franchisor's business. In this situation the riskiness of the franchisee's position favors the application of the securities laws, for if the franchisor folds, the franchisee's position is lost.⁷⁶

4. The fourth situation has none of the securities qualities of the others. That is the situation where the franchisor is adequately capitalized and where the franchisee has control over the franchised business. The franchisee is paying for site-selection assistance, the established name, the training, continuing management advice, and the cost of setting up the physical plant of the business. In return, the franchisor has acquired a new outlet for his inventory or services. This type of situation is not within the scope of the '33 and '34 Acts under present definitions. The investor has really invested in his own business and has been licensed to use the franchisor's name and method of doing business. He has also purchased other services from the franchisor, but has not been forced to relinquish managerial control over his business. Everyone benefits from this arrangement.⁷⁷ It is doubtful that this plan could ever be brought within the fed-

⁷⁴ *Id.*

⁷⁵ It is true that the franchisee may be able to salvage most of his investment if the franchisor folds, assuming he has some knowledge of the business as the franchisee in *River City*. However, many franchisees have no previous business experience in the field in which they purchase a franchise.

⁷⁶ The franchisee can never rescue that part of his investment which went down the drain with the rest of the franchisor's "risk capital."

⁷⁷ There are several reasons for the "boom" in franchising. First, in the expanding economy of the 1960's, the entrepreneur found himself without enough capital to satisfy the increasing demand for goods and services. The manufacturer, on the other hand did not have sufficient capital both to accelerate production to supply existing outlets in the face of increasing market demands and to establish new outlets in areas where a ready market awaited his product. The solution to the dilemma was the popularization of a system which provided the manufacturer

eral or state definition of a security without Congress enacting legislation redefining the franchise as a security, but this does not mean that the other forms of franchises cannot be regulated through the use of the federal or state securities laws. Additionally, it does not follow from this conclusion that the "ordinary" franchise need not be regulated, or that the "ordinary franchisee investor" does not need the same kind of legislative protection as franchisees who invest in more suspect types of franchises. Under the present definition of a security, it is doubtful that the courts would accept a redefinition of investment contract by the Commission in order to bring all franchise situations within the securities laws.⁷⁸ Some franchise arrangements simply do not satisfy the conception held by the courts of what constitutes a security. Hopefully this type of franchise will be quickly and effectively regulated without any Commission redefinition, which may be struck down by the courts as beyond the scope of the Securities Act of 1933.⁷⁹

VI. LEGISLATIVE PROPOSALS

Even though the federal and state securities laws provide remedies to franchisees in situations when the sale of the franchise constitutes a sale of an investment contract, franchising still remains unregulated by any single comprehensive piece of legislation. Some states have responded to the need for regulation by redefining the franchise as a security in order to bring it within the licensing provisions of their state blue sky laws.⁸⁰ Others have enacted a completely new disclosure law to handle the problem of fraud in the sale of franchises.⁸¹ Two bills have been introduced in Congress dealing with the problem of fraudulent sales of franchises through the '33 and '34 Acts,⁸² two others have been introduced to deal

with new outlets without draining his capital and one which enabled the entrepreneur to exist side-by-side with the giants: franchising. LAW OF FRANCHISING §§ 5-6.

⁷⁸ The Securities and Exchange Commission could attempt to redefine investment contract by a rule, but the courts would probably hold such action to be beyond the scope of the meaning intended by Congress.

[T]he term investment contract had been used in many state blue sky laws prior to the enactment of the federal securities laws and that its meaning as used in state laws had been determined by state courts. [The Court in *Howey*] concluded that when Congress introduced this term into the federal securities laws it intended it to have the same meaning as had been previously developed under state law.

1970 *Hearings* at 707.

⁷⁹ The Commission is not given a wholesale power to legislate under § 19(a). The Commission can only go so far in imposing new substantive requirements under the Act in the guise of defining interpretative rules. See L. LOSS, SECURITIES REGULATION 1942-43 (1961).

⁸⁰ The Wisconsin Securities Commissioner classified franchises as securities in January 1970. WIS. AD. RULES § 1.02(2) (1970).

⁸¹ California enacted the "Franchise Investment Law" CAL. CORP. CODE §§ 31000-31516 (West Supp. 1971).

⁸² S. 3844 was introduced on May 15, 1970 by Senator Harrison Williams, Jr. A companion bill was introduced in the house by Mr. Stuckey, H.R. 1902, on August 13, 1970. Franchise legislation has been introduced on other aspects of the franchise relationship with

with the problem through the FTC Act,⁸³ others have been introduced to deal with other aspects of the franchise relationship.⁸⁴

To date, legislation introduced in Congress has attempted to handle the fraud problem through disclosure rather than by setting out substantive standards for franchises or practices. The purpose of the proposed bills is, of course, to provide the franchisee with all the facts about the franchisor *before* he buys the franchise. To this end, two of these bills attempt to give the Securities and Exchange Commission authority over the franchise problem. The most publicized of these, the "Franchise Full Disclosure Act," was introduced into Congress by Senator Harrison Williams, Jr. on August 15, 1970⁸⁵ and requires prospective franchisors to disclose financial and other business data to the Commission for approval prior to any sale of franchises. The bill further provides that the registration information must be delivered to the prospective franchisee at least 48 hours prior to the time he purchases, otherwise, the franchisee may later void the sale at his discretion. Finally, the bill requires disclosure of any financial arrangement the franchisor has made with any celebrity for the use of his name in connection with the franchisor's business operation. Under this proposed legislation, the franchisee would have a cause of action against the franchisor for any false or misleading statement or misrepresentations in making the sale. There are no substantive provisions dealing with termination and buy-back procedures, though these must be explained fully in the prospectus.

A similar bill was introduced in the House of Representatives,⁸⁶ differing from the Williams Bill only in that it preempts state laws on franchise disclosure and limits the civil liability of the franchisor to the actual damages suffered by the franchisee.

Both of these bills evolved out of a comprehensive study of the problem of franchising.⁸⁷ The advantage of both bills is, of course, that they provide for pertinent information to be given to the franchisee before he

varying degrees of success. Senator Hart introduced "Fairness in Franchising Act" which attempted to supplement the antitrust laws "by providing for fair competitive practices in termination of franchise agreements." S. 1967, 91st Cong., 1st Sess. (1970).

⁸³ Two new bills have been introduced in the last session of Congress by Senator Williams and Senator Vance Hartke. The Williams Bill is called the "Franchise Fair Practices Act of 1971." S. 2399, 92d Cong., 1st Sess. (1971). It is patterned after the disclosure bill which he introduced in the 91st Congress, except S. 2899 provides for the FTC to administer the Act rather than the S.E.C. Mr. Hartke's bill, the "Franchise Fair Practices Act of 1971," S. 2870, 92d Cong., 1st Sess., is patterned after the California Franchise Investment Law. Again, the regulating body is to be the FTC.

⁸⁴ 15 U.S.C. § 45(a) (1970).

⁸⁵ S. 3844, 91st Cong., 1st Sess. (1970).

⁸⁶ H.R. 1902, 91st Cong., 1st Sess. (1970).

⁸⁷ See 1970 *Hearings*; See also 1970 *Report*. No further action was taken on this by the 91st Congress.

purchases the franchise, information that must be given regardless of whether the franchise constitutes a security or not. Thus enactment of either bill would avoid the difficulty that courts seem to have had in fitting the franchise contract within the definition of an investment contract.

Another advantage of the bills is that they provide for regulation by the Securities and Exchange Commission, thereby avoiding the creation of another bureaucracy. The bills are fashioned after the Securities Act, so the Commission would have no difficulty in implementing the bill into existing procedures.

There are difficulties with the two bills, the most salient problem being a political one, however. Because of a strong franchisor lobby neither bill is likely to be passed in the near future. Hearings on the bills were held, but the 91st Congress took no further action on either.⁸⁸ Since both bills were introduced into Congress in 1970, franchisees have already had a long wait for some form of legislation to handle the fraud problem.

In California a disclosure bill, administered by the same agency which administers the state's securities laws, has met with success. Prior to the enactment of the "Franchise Investment Law," sales of franchises were regulated only to the limited extent to which the Corporate Securities Law of 1968 applied,⁸⁹ and the franchise problem in California reached alarming proportions because franchisors were failing to provide complete information regarding the franchisor-franchisee relationship, including the prior business experience of the franchisor.⁹⁰ The FIL, which went into effect on January 1, 1971, requires full disclosure from all franchisors and those who offer or sell franchises in California must register with the Commissioner of Corporations. It requires the franchisor to keep accurate records and creates both civil and criminal penalties for fraudulent practices and failure to register. Those who are exempt from registration are not exempt from liability. In order to be entitled to an exemption, a franchisor must have a \$5,000,000 net worth and must have at least 25 franchisees conducting business at all times preceding the offer or sale to a particular franchisee or must have conducted the business which is the sub-

⁸⁸ Lobbying against the Stuckey bill may come from quarters other than the franchisors. It provides for preemption of any state legislation in the franchise area. Many would feel that this would represent further encroachment on states' rights.

⁸⁹ 49 OPS. CAL. ATT'Y GEN. 124 (1967). Before enactment of the FIL, the Department of Corporations estimated that only about six franchises were registered under the Attorney General's opinion of the law. It was felt that the securities approach was inadequate and was not intended to include the area of franchises. 1970 Report at 96.

⁹⁰ "Every indicator available to the Commissioner of Corporations to the Attorney General and other law enforcement agencies, and to other governmental agencies concerned with business problems, points out that the problems in connection with the sale of franchises are accelerating. Public confidence in the franchise industry should be maintained if it is to remain a significant part of the economy and the maintenance of that confidence may require reasonable and sensible legislation." A. Pierno, *Franchise Regulation—The Need for a New Approach*, 44 L.A. BAR BULL. 501 (1969).

ject of the franchise continuously for five years preceding such offer or sale. If the parent corporation meets these requirements then the franchisor is exempt.⁹¹

The exemptions exclude from registration those whose sales are outside the ambit of the "risk capital" test for a security since the fact that the franchisor has an established track record indicates that it is probably able to supply goods and services commensurate with the franchise fee. It is further evidence that the franchisors probably are deriving profits from supplying goods and services to their franchisees rather than from the initial sale of the franchise, and it is also unlikely that a company with a net worth of \$5,000,000 would seek risk capital through the sale of franchises when traditional means would certainly be available. So, to a significant extent, the FIL exempts from registration those who have been in the non-security classification under the old California Corporations Code.⁹²

The FIL is patterned after disclosure provisions in the California securities law and the administrative body is authorized to undertake remedial action. The franchisor is required to disclose to the franchisee complete information on fees and charges, termination and modification provisions, and any obligations of the franchisee or sub-franchisee to purchase goods from any outside sources designated by the franchisor. The law further provides that a stop order may issue if after examination of the registration statement, the Commissioner finds that the offer or sale of the franchise will constitute fraud or deceit upon the purchaser, that there has been a failure to comply with any ruling which requires the impounding of the franchise fees because of the inadequacy of financing by the franchisor, or that there is involved in the sale any person who is subject to an order by another administrative agency or who, therefore, has been convicted of a felony and may create risks to the prospective franchisee. Notice of the stop-order must be promptly given and a hearing must be held by the hearing officer immediately.

The escrow provisions of the law are designed to help assure that the franchisee who puts up money for a franchise does not end up losing it because of inadequate capitalization by the franchisor. The law further provides that advertisements may not be placed in magazines without being filed with the California Corporations Commissioner three days before publication, and the Commissioner may halt the use of any ad if he finds it to contain anything false or misleading. If the ad includes only certain specified information, it need not be registered.

It is worthwhile to note California's legislative solution to the problem of franchise disclosure because so much of the California experience has

⁹¹ "California Franchise Investment Law," CAL. CORP. CODE §§ 31000-31516 (West Supp. 1971).

⁹² Compare the FIL with CAL. CORP. CODE § 25500 (West Supp. 1971).

heralded developments on the federal level. Unfortunately it does not appear that in the case of a franchise disclosure act the Congress will quickly follow California's lead. Neither the William's "Franchise Full Disclosure Act" nor the Stuckey bill seem to be near enactment by Congress. But some type of immediate action is necessary on the federal level and the SEC could be instrumental in bringing about a quick solution to the disclosure problem.

First, it is necessary to understand that the SEC cannot simply redefine the term "investment contract" to include all franchise situations. The definition of investment contract was worked out by courts under state blue sky laws before Congress incorporated it into the '33 and '34 Acts⁹³ and Congress no doubt intended it to have a meaning quite similar to the one it had under state law. The courts might permit the Commission great leeway in redefining the terms by rule, but only within the limits of the definition intended by Congress. They would not permit a redefinition by the Commission to include the "ordinary franchise" contract because it would stray too far from the Congressional intention.

The SEC might however attempt to redefine investment contract by rule to include those franchise situations outlined in the 1967 Opinion of the California Attorney General.⁹⁴ This would have the effect of alerting those franchisors who are poorly capitalized *or* who sell contracts in which the franchisee plays only a ministerial role that they must register under the Securities Act of 1933. But as stated above, the Commission's power to redefine terms in the Act by a rule is open to question.⁹⁵ The general rule-making power of the Commission is found under § 19(a) of the Securities Act of 1933:

The Commission shall have the authority from time to time to make, amend, and rescind such rules and regulations *as may be necessary to carry out the provisions of this title*, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms used in this subchapter. Among other things, the Commission shall have authority, for the purposes of this subchapter, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement⁹⁶

The language "as may be necessary to carry out the provisions of this title" appears to grant a general power to legislate, but this general language

⁹³ "The term 'investment contract' is undefined by the Securities Act or by relevant legislative reports. But the term was common in many state 'blue sky' laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection." *Howey supra*, note 33 at 298.

⁹⁴ *Supra* note 89.

⁹⁵ L. LOSS, SECURITIES REGULATION 942 (1961).

⁹⁶ 15 U.S.C. § 77s (1970) (emphasis added).

should be read in the light of the more specific language which follows. The Commission could redefine investment contract by a rule on the theory that it was defining a "technical term."

Although the "risk capital" test for an investment contract was developed subsequent to congressional enactment of the Securities Acts, the theory has gained enough judicial acceptance that the courts would probably accept an administrative redefinition which included the test, and *Venture Investment* stands as some evidence of this judicial willingness. Enactment of a rule would have the force of law in contrast to the mere issuing of a release. Therefore, the courts could not ignore a Commission-adopted rule.⁹⁷

The "rule-adoption" method would probably be the quickest way to provide the equivalent of disclosure legislation on the federal level. It would require no action by Congress with all the attendant delays, and it would bring a part of the franchise problem under the scrutiny of an agency which is accustomed to dealing quite effectively with disclosure problems.⁹⁸ The SEC also possesses the requisite flexibility to adjust the disclosure requirements to fit the particular security.⁹⁹

The most glaring problem in this approach is that the California experience showed that very few franchisees actually registered under the "limited" approach. Perhaps the highly efficient enforcement policies of the Commission would result in more registrations. But the California Commission was also active in the area,¹⁰⁰ and there appears to be a danger that the experience on the federal level might parallel that in California. The solution to this problem is to bring *all* franchises within the purview of a single agency and a single piece of disclosure legislation. In California, the method chosen to require all franchisors to disclose was to enact an entirely new piece of legislation, requiring the Commission in charge of securities to administer the law.

On the federal level, quick enactment of comprehensive disclosure legislation administered by the SEC is not likely; however, a much simpler solution would be for Congress to amend the '33 and '34 Acts to bring every franchise contract within the definition of an "investment contract"¹⁰¹

⁹⁷ Unless they found that the Commission had strayed too far from the original meaning of the Act.

⁹⁸ The Commission could not require all franchisors to register on the theory that it is necessary in order to regulate those which are securities. Section 5(a) says specifically that a registration statement is required for security.

⁹⁹ L. LOSS, SECURITIES REGULATION 216 (1961).

¹⁰⁰ The California Corporations Commission accepted the letter of a reputable attorney as enough to exempt his client from registration. Although this is similar to a no action letter, such action simply would not be feasible on the national scale.

¹⁰¹ Legislatively, this may be a much simpler solution than enacting an entirely new piece of legislation. Presumably, the political pressures would be just as strong against this type of regulation as against the Williams Bill. On the other hand, the SEC at the time hearings were being held on the matter of proposed franchise disclosure legislation opposed the idea that

and, consequently, within the disclosure provisions of these Acts. Admittedly, the franchise contract does not fit the normal conception of a security in all cases, but creation of the fiction may well be the best way to get quick action on the franchise disclosure problem.

Normally, those registering under the Securities Act of 1933 must fulfill Schedule A requirements. But under § 7, it is provided

that the Commission may by rules or regulations provide that any such information or document need not be included in respect of any class of issuers or securities if it finds that the requirement of such information or document is inapplicable to such class and that disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement.¹⁰²

Since franchises involve special circumstances, certain parts of Schedule A may be inapplicable. On the other hand, other information more meaningful to a prospective franchisee should be included. In addition, the Commission should consider enacting rules or regulations describing how far the information in the registration statement may be summarized or what may be omitted from the Schedule A requirements in order to permit the prospectus to be used for purposes of § 5(b)(1). In other words, the prospectus mailed to the prospective franchisee need not be as detailed as the registration statement as long as it does not include "any untrue statement of material fact" or omit "to state any material fact required to be stated . . . in the light of the circumstances under which such prospectus is or is to be used."¹⁰³

The disclosure laws recently proposed have used the first four sections of Schedule A almost verbatim. Thereafter, the authors of the legislation have departed from Schedule A in order to make the information more meaningful to franchisees. Many of the requirements of Schedule A could be modified slightly to accommodate the franchise situation and the proposed disclosure requirements in these new bills could serve as models for a special registration form.¹⁰⁴

Other proposals for disclosure legislation have been introduced in the first session of the 92nd Congress. On August 2, 1971, Senator Harrison Williams, Jr. introduced the "Franchise Fair Practices Act of 1971."¹⁰⁵

the SEC should be the regulatory body for franchising. Its change in attitude or active encouragement of such amendment would have a tremendous effect on Congress.

¹⁰² L. LOSS, *SECURITIES REGULATION* 216 (1967). "It has been the Commission's policy from the beginning to adapt the specifications of Schedule A to the circumstances of particular types of issuers by promulgating a substantial number of separate forms. At present there are seventeen registration forms." *Id.* at 216.

¹⁰³ 15 U.S.C. § 77j(b) (1970).

¹⁰⁴ See disclosure requirements set out in S. 239, 92d Cong., 1st Sess. § 7 and S. 2870, 92d Cong., 1st Sess. § 7 (1971).

¹⁰⁵ The "Franchise Fair Practice Act of 1971" *supra* note 83.

This bill attempted to provide not only for full disclosure but also for substantive regulation of various aspects of the franchise agreements by the FTC under the FTC Act. The bill provides that it "shall constitute an unfair and deceptive act or practice in commerce under the FTC Act" for any franchisor to sell or offer a franchise unless a disclosure statement filed pursuant to other sections of the Act is in effect. Thus, non-disclosure is redefined as an unfair and deceptive trade practice. It makes it illegal for the franchisor to use any misrepresentation to obtain money from a franchisee or "to engage in any transaction, practice, or course of business which operates or would operate as an unfair or deceptive act or practice with respect to a franchisee." The franchise contract is voidable at the will of the franchisee if a valid disclosure statement is not delivered seven days before the contract or agreement is signed. The bill provides for those elements which must be included in the disclosure statements and for a private right of action by anyone damaged by the misleading statements in a disclosure statement and the damage section authorizes the plaintiff to receive treble damages. The bill further provides that all other disclosure or other requirements of state law shall be preempted. A violation under this act is automatically a violation of the FTC Act. The Commission is authorized to use all of the rights and remedies with respect to the FTC Act to enforce this law, including its right to enjoin unfair trade practices.

The "Franchise Fair Disclosure Act of 1971" was introduced into Congress on November 17, 1971 by Senator Hartke.¹⁰⁶ This bill is not materially different from the Williams bill except that it provides that the FTC has authority to enact one exemption from registration of a disclosure statement. The exemption applies if the franchisor or its parent company has a net worth of \$5,000,000 and if the franchisor has during a five year period preceding the offering had 25 successful franchisees in operation or if the franchisor had operated such business successfully for five years and specified information is given to the franchisee 48 hours prior to the execution of the contract.

These bills were probably introduced in answer to the opposition of the SEC to the two former bills which provided for regulation by the SEC. But the SEC has since modified its position on the question. The two bills provide for substantially the same disclosure provisions which could be enacted by rules or regulation under the '33 and '34 Acts. Besides, the FTC is not a body which is as accustomed to handling registration statements as the SEC and there is no use enacting an entirely separate piece of legislation to accomplish what could be done by simple amendment of an already comprehensive legislative scheme.

For these reasons, Congress should amend the '33 and '34 Acts immediately to include franchises within the definition of investment contract.

¹⁰⁶ *Id.*

The Commission should then get the rule-making machinery in operation to require all franchisors to make the necessary disclosures to prospective franchisees. Any further delay will cause more and more franchisees to wonder where franchise disclosure legislation was when they needed it.

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